

World Financial Markets 4

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Global debt: assessment and long-term strategy

The ramifications of the international debt problem and how to deal with it continue to be principal international financial issues. The first phase of dealing with the debt problem — the acute crisis atmosphere of last fall — is now behind us, as a result of quick and decisive actions on the part of governments, official institutions, and banks. The immediate liquidity problems were handled through the provision of short-term bridge financing, which has been followed by the adoption of IMF stabilization programs by a number of the major borrowers.

The second phase is now in progress. Some of the stabilization programs had to be drawn up hurriedly and therefore may require revision and strengthening as the passage of time permits better assessment of the nature of the problems and the initial policy responses. Indeed, for many developing countries it will take several years of perseverance to yield the needed current account adjustment and improvement in debt-servicing capacity. Therefore, it is necessary that a

long-term strategy be developed for adequate financing of the deficits in the interim period.

This article identifies five key issues to be considered in developing such a strategy and evaluates the two principal approaches that have been presented so far. One approach stresses short-term, liquidity aspects of the international debt problem and focuses almost exclusively on the need for deflationary policies in the LDCs to promote balance of payments adjustment, whatever the prospects for OECD recovery. The other emphasizes longer-term, solvency aspects and seeks a solution that has an inflationary bias, in which industrial countries would pursue expansionary policies and portions of LDC debt would be written off or transferred to new institutions. Both approaches, however, suffer the drawback that they are disruptive to borrowers or to lenders, which could lead to a worsening of the present situation. The former approach risks forcing excessive costs on borrowers that would increase the chances of nonrepayment of interest or principal, while the latter destroys incentives for lenders to continue to provide additional financing.

A third strategy, therefore, has to be followed that more carefully bal-

ances the needs for adjustment and financing. Based on a disaggregated, country-specific analysis of the balance of payments and external debt prospects of 10 key LDC borrowers, it now appears that the duration of the problems facing several major LDC borrowers, especially those in Latin America, may take longer than was originally expected. A sustained OECD recovery averaging 3% per annum in the rest of this decade is an indispensable ingredient to resolve the international debt issue, but it may not be sufficient, by itself, to solve the problems of some of the major LDC borrowers in the next few years. There is also need for substantial LDC current account adjustment, not only through domestic-demand management in the next couple of years, but also through structural changes to increase LDCs' exports over the long term. The latter is vital to resumption of LDC economic growth.

As regards financing, two types of initiatives are called for. First, considering that it may well take the better part of this decade for some of the key LDC borrowers to reestablish regular access to credit markets, incentives are needed to assure that adequate bank financing is forthcoming in the interim. Second, ways must also be found for substituting nonbank sources of finance, especially long-term development assistance and foreign direct investment, for short- and medium-term bank credits in order to reduce the share of bank financing to the LDCs.

Dimensions of the problem

The difficulty of dealing with the international debt problem stems from the fact that it is a highly complex issue. One complication is the large number of countries involved.

It has become a global issue that, directly or indirectly, affects almost all countries, borrowers and creditors alike. About 30 developing and Eastern-bloc countries are now in arrears or have sought debt renegotiation, and others are feeling the impact of the slowdown in international lending, cutbacks in short-term credits, and a stiffening in lending terms. The countries seeking debt renegotiations vary considerably with respect to the amount, structure, and composition of external debt, as well as to the need for debt relief, such that each country must be dealt with separately.

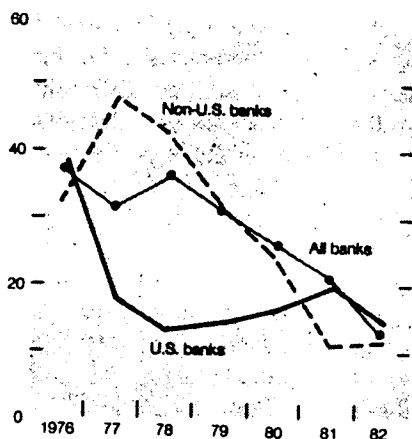
The problem is also complicated by the competing objectives that must be reconciled with one another: There is need for the LDCs to adjust and yet restore growth; there is also need for the banks to reduce concentrations of credit to certain countries, and yet to extend new loans to countries that merit support. The solution, therefore, requires treading a very narrow path between balance of payments adjustment and additional financing. Tilting too far in the direction of adjustment or financing may jeopardize the entire strategy. The solution also requires difficult judgments to be made about the extent to which a country can be expected to accept cutbacks in living standards without adverse effects on political and social stability. For these reasons, there is no quick or easy solution to the debt problem, which has at least five key aspects to be addressed.

LDC debt-servicing capacity

One of the major reasons for the emergence of the international debt problem is that the external debt of the developing countries has risen faster than their exports, eroding their debt-servicing capabilities. For the 21 major LDC borrowers,

Chart 1

Growth of bank lending to all LDC borrowers
annual percent change in banks' claims in dollar terms



growth of external debt has averaged over 21% per annum since the mid-1970s and has slowed significantly only within the past year or so (see Chart 1). The debt buildup has been especially rapid for some of the relatively low-debt countries in the group such as Thailand, Ivory Coast, Nigeria, and Ecuador, where it has exceeded 30% per annum since the mid-1970s (see Table 1). It has also averaged close to 25% or more per annum for key borrowers such as Argentina, Mexico, Venezuela, South Korea, and the Philippines.

For the most part, LDC exports of goods and services kept pace with the debt buildup during the inflationary environment of the 1970s. However, exports slowed significantly in the 1980s and even fell in nominal terms in the past two years because of world recession and depressed commodity prices. More-

over, import adjustment, while significant in 1982, lagged the export downturn, and net interest payments for the group of 21 countries doubled, from \$21 billion in 1980 to \$43 billion in 1982, reflecting higher debt levels and interest rates. This contributed to a significant deterioration in the combined current account deficit of the major LDC borrowers and to a sharp rise in their total external debt in relation to exports of goods and services, from less than 125% in 1980 to nearly 180% in 1982 (see Chart 2). The debt buildup has been particularly great in Latin America, where it climbed to about 260% of exports in 1982. Argentina's debt/export ratio approached 390% then, while Brazil's stood at 345%.

While the developing countries require additional credit during the current adjustment phase, their external debt buildup needs to be brought more in line with their debt-servicing capabilities over the longer term. For the countries already experiencing debt-servicing problems, a reduction of their debt/export ratios is an important prerequisite to restoring regular access to credit markets. Clearly, there is no absolute theoretical level of the ratio that applies to all countries.* In the stock market, it is widely recognized that a firm with a high growth potential can have a larger price/earnings multiple than one with a low earnings growth potential. Similarly, a country with a high export-growth potential can have a comparatively large debt/export ratio without necessarily being a higher risk country. But, it must also be recognized that there are

Table 1

Growth of total external debt and exports for 21 major LDC borrowers
percent per annum

	Total external debt			Exports of goods, services, and private transfers		
	1976-80	1981-82	1976-82	1976-80	1981-82	1976-82
Latin America						
Argentina	28.1	19.4	25.6	25.6	-7.5	15.1
Brazil	24.4	14.3	21.4	18.7	1.5	13.5
Chile	16.2	24.0	18.4	28.0	-4.5	17.7
Colombia	15.1	12.1	14.2	21.8	-7.0	12.8
Ecuador	45.2	18.4	37.0	21.1	-5.6	12.8
Mexico	21.9	26.9	23.3	30.8	11.1	24.8
Peru	8.0	9.0	8.3	22.9	-7.6	13.3
Venezuela	40.9	12.9	32.2	17.1	-4.6	10.5
Asia						
Indonesia	13.3	12.3	13.0	25.9	-4.0	16.5
Korea	27.0	16.6	23.9	30.6	12.1	25.0
Malaysia	20.4	45.4	27.1	27.1	-4.0	17.3
Philippines	26.3	30.1	27.4	19.6	0.1	13.7
Taiwan	19.4	7.4	15.8	29.1	6.5	22.2
Thailand	40.7	16.2	33.2	23.2	3.9	17.4
Middle East and Africa						
Algeria	27.0	-3.2	17.5	23.2	-2.4	15.2
Egypt	22.8	18.6	21.5	27.8	-4.3	17.6
Israel	16.8	11.8	15.8	18.7	-0.3	12.9
Ivory Coast	39.4	24.7	35.0	20.0	-13.5	9.3
Morocco	33.2	18.2	28.7	11.3	-6.4	5.9
Nigeria	32.9	42.6	35.6	24.5	-26.6	7.0
Turkey	32.5	7.9	25.0	12.1	27.1	16.2

*Some analysts contend that external debt should be measured relative to GNP rather than to exports. The latter is used in this analysis on the grounds that external debt must be serviced in foreign exchange, rather than local currency. Hence, exports are more relevant for measuring debt-servicing capacity and vulnerability to liquidity problems, especially in developing countries prone to inappropriate exchange rate policies and restrictions on trade and capital flows.

Chart 2

Debt/export ratios of 21 major LDC borrowers
external debt as % of goods and services

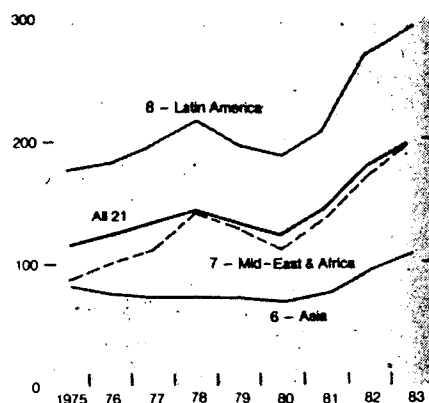


Table 2

Exports of goods, services, and private transfers as percent of nominal GNP

	1975	1982
21 major LDC borrowers	18	22
Latin America	11	15
Argentina	9	16
Brazil	8	8
Chile	26	24
Colombia	17	13
Ecuador	26	19
Mexico	7	17
Peru	13	20
Venezuela	37	30
Asia	28	34
Indonesia	23	22
Korea	30	44
Malaysia	47	53
Philippines	21	21
Taiwan	41	55
Thailand	21	25
Middle East and Africa	24	26
Algeria	37	35
Egypt	22	23
Israel	39	49
Ivory Coast	39	32
Morocco	28	26
Nigeria	28	22
Turkey	9	17

limits to a country's ability to service external debt. Thus, if a country with a high debt/export ratio does not have a corresponding high export-growth potential, the probability of encountering debt-servicing difficulties is greater.

The incidence of debt reschedulings has been considerably higher for countries with debt/export ratios that exceed 160%. Virtually every country whose ratio climbed beyond 200% at one time or another has been forced to reschedule portions of its debt. As the world economy enters a less inflationary environment in which bank credit expansion to LDCs is slower, the relevant threshold range indicating the likely onset of debt-servicing problems may be considerably below the 160%-200% range drawn from experience in the 1970s and early '80s.

LDC debt/export ratios can be improved through a slowdown in debt accumulation, an acceleration of exports, or both. With world recovery just getting under way and LDC exports still depressed, any improvement in the near future will probably have to come from a sharp slowing in debt accumulation brought about by a sizable reduction in LDC current account deficits. A current account reduction of about \$20 billion is expected for the major LDC borrowers this year, reflecting further declines in merchandise imports and net interest payments. An additional current account improvement of about \$14 billion is expected next year as LDC exports begin to recover.

Over the long term, export expansion holds the key to sustained LDC current account adjustment and improved debt-servicing capacity. OECD recovery clearly is essential to boost LDC exports, but there is also considerable room for many of the developing countries, particularly those in Latin America,

to enhance their export potential through the adoption of realistic exchange rate policies and reduced reliance on import-substitution policies. As is shown in Table 2, exports of goods and services relative to GNP in the major Latin American countries are less than half of those of the major Asian LDC borrowers and well below those of the Middle East and African borrowers. A fundamental shift in commercial policies and exchange rate management in Latin America is needed to boost those countries' long-term export prospects.

Short-term debt

A significant part of the expansion of LDC external debt has been in the short-term area. As of year-end 1982, short-term debt (original maturity of one year or less) for the major LDC borrowers is estimated to have been over \$130 billion, or one-quarter of their total external debt. There was a tendency in the past not to include short-term debt in external-debt calculations. This was partly because only very limited data on short-term debt were available. Also, such debt was assumed to be trade-related and, therefore, automatically rolled over. For a number of countries, however, as long- or medium-term debt became more expensive and less readily available, short-term debt was used increasingly for long-term balance of payments financing. Moreover, as total and short-term debt increasingly became a matter of concern, rollover proved to be far from automatic.

What is a proper level of short-term debt? Again, there are no hard and fast rules, although some rough guides need to be constructed based on international trade transactions. Capital goods imports typically account for 25%-35% of total LDC imports, and are financed chiefly by medium- and long-term

Table 3

External debt, total and short-term in relation to trade

billions of dollars

	Total external debt		Short-term debt^a	
	end-1982	in excess of 200% of exports^b	end-1982	in excess of 3-mo. imports^c
21 major LDC borrowers	514.5	97.8	132.5	87.4
Latin America	288.1	80.7	75.7	59.2
Argentina	38.8	18.0	7.3	6.1
Brazil	86.3	34.3	16.7	11.9
Chile	17.2	4.9	3.2	2.3
Colombia	10.2	0.0	3.3	2.0
Ecuador	6.6	0.9	1.3	0.7
Mexico	84.6	20.4	25.8 ^d	22.2 ^d
Peru	11.2	2.2	3.2	2.3
Venezuela	33.2	0.0	15.0	11.7
Asia	108.8	2.7	29.0	10.6
Indonesia	21.9	0.0	2.9	0.0
Korea	37.2	0.0	10.4	4.6
Malaysia	8.6	0.0	1.7	0.0
Philippines	20.7	2.7	7.8	5.8
Taiwan	9.3	0.0	4.0	0.0
Thailand	11.1	0.0	2.2	0.2
Middle East and Africa	117.6	14.4	27.8	17.6
Algeria	14.8	0.0	0.7	0.0
Egypt	21.8	3.3	3.2	1.2
Israel	28.0	4.1	13.5	12.3
Ivory Coast	8.4	2.1	2.0	1.5
Morocco	10.8	2.4	1.0	0.1
Nigeria	11.2	0.0	3.0	0.0
Turkey	22.6	2.5	4.4	2.5

^aBased on average 1982 debt level in relation to exports of goods and services.^bOriginal maturity of one year or less.^c1982 merchandise imports.^dIncludes nearly \$10 billion of Mexican short-term debt that has now been restructured.

loans (e.g., World Bank project loans, Exim Bank loans, or suppliers' credits). The remaining imports normally are financed by short-term borrowings for up to 90-120 days on average. Some countries obtain a certain amount of pre-export financing, particularly for commodities such as oil and gold, which in effect speeds up the receipt of foreign exchange by exporters of such goods. Thus, after making allowance for such pre-export financing, which varies from country-to-country, and for the portion of imports financed by medium- and long-term loans, short-term debt generally should not exceed an amount equivalent to approximately three months of merchandise imports.*

As shown in Table 3, however, some countries' short-term debts have exceeded three months of imports, and have been well in excess of what is needed to cover trade requirements. The table also shows that some countries that do not have total debt in excess of the threshold ratio of 200% of exports have, however, accumulated "excess short-term debt."

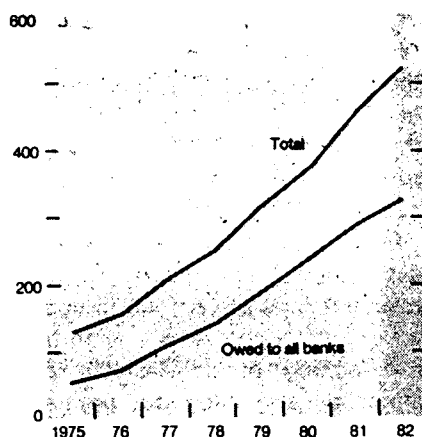
Two conclusions follow from this assessment. First, restructurings or reschedulings are helpful in coping with liquidity problems arising from a bunching of debt-service payments by stretching out payments and buying time for adjustment programs to yield results. Most of the recent debt renegotiations have entailed reschedulings of amortization of medium- and long-term debt that fall due this year and that must be rolled over. Agreements by creditors to maintain existing levels of short-term credits have also been reached. So far, Mexico is the principal country to have portions of its short-term debt (nearly \$10 billion) stretched out into credits of seven to eight years. Restructurings or reschedulings, however, will not solve problems of excessive debt, since they do not reduce a country's overall indebtedness, or affect its debt/export ratio.

Second, it is essential that information on short-term debt be provided on a much more timely and comprehensive basis so that both borrowers and lenders can be aware more promptly of developing problems. Also, there is need for the IMF to assist countries in formulating guidelines covering short-term debt accumulation and for banks to develop their own internal yardsticks to forestall over-reliance

*While most major LDC borrowers are not important money centers, the commercial banks in a few LDCs have sizable foreign exchange assets in the form of redeposits related to their short-term foreign exchange liabilities, which also should be considered in assessing a country's gross short-term debt.

Chart 3

**External debt of 21 major
LDC borrowers**
in billions of dollars



by LDCs on short-term debt.

Concentrations of bank credit

While many borrowing countries need to curb their debt/export ratios and reduce their reliance on short-term debt, commercial banks will be striving to lower ratios of LDC loans to bank capital. The growth of bank lending to all LDCs has averaged slightly over 20% per annum since 1975; it has been even higher, 25% per annum, to the major LDC borrowers. The initial surge after the first oil shock occurred during the 1974-75 recession. Lending by U.S. banks to the LDCs slowed considerably in the second half of the 1970s as private credit demand picked up in the United States (see Chart 3). Nonetheless, total bank credits to developing countries continued to expand rapidly, partly because of increased participation in international lending by non-U.S. banks, such as domestically oriented European banks, Japanese banks, and new Arab institutions. Lending by U.S. banks accelerated again toward the end of the decade, partly because a growing number of smaller, regional banks increasingly participated in international loan syndications.

Even with these new entrants, the rate of increase of bank lending to the LDCs outstripped the growth of bank capital, which for the major U.S. banks has been running in the vicinity of 9%-10% since the mid-1970s. (Data on bank capital for other countries are not comparable to those for U.S. banks.) The result was a substantial increase in loans outstanding to LDC borrowers in relation to U.S. bank capital and increased concentrations of credits to a few countries. As of mid-1982, credits to Mexico represented almost 50% of the capital of the nine largest U.S. banks, and those to Brazil and Argentina about 45% and 20% respectively. Together,

credits to these three LDC borrowers constituted about 115% of capital of the largest U.S. banks, and roughly half of these banks' claims on LDCs.

While it is desirable to reduce lending concentrations in the future, it is also imperative that this be done within the context of a moderate expansion of new bank lending to the LDCs. IMF standby programs for some of the major LDC borrowers call for an overall expansion of new bank credits of at least 7% per annum in order to assure orderly balance of payments adjustment. Such targets may be difficult to achieve, considering that a number of smaller, regional U.S. banks, which account for about 20% of all U.S. bank loans to LDCs, and some non-U.S. banks have been reluctant to increase their LDC exposures. Should a number of these banks either hold exposures unchanged or reduce them, the remaining major U.S. and foreign banks would have to extend net new credits at a rate of 9%-10% per annum for the overall minimum target set by the IMF to be met.

In such circumstances, reductions in LDC loan/capital ratios for U.S. banks would hinge primarily on significant expansions of bank capital. If credits of the nine largest U.S. banks to the LDCs were assumed to expand at a rate of 10% per annum, and bank capital to grow at a 20% per annum rate, credits of these banks to the three principal LDC borrowers would decline from 115% to about 75% of their capital in five years.

Insufficient official financing and foreign direct investment

The rapid growth of bank lending to LDCs has resulted, in part, from the inability of official financing, bond issuance, and foreign direct investment to keep pace with LDC financing requirements. The propor-

Table 4

Impact on OECD of a uniform 3% cutback in LDC real GNP growth¹

	<u>Change in real GNP (%, 1983)</u>	<u>Change in current account (\$ billions, 1983)</u>
OECD	-0.8	-15
United States	-0.5	-5
Japan	-1.1	-3
Europe	-0.8	-7

¹Assuming no compensating policy changes by industrial countries. If growth cutbacks are concentrated in Latin America, the adverse consequences are more severe for the United States, but less severe for Japan and Europe.

tion of net capital flows to all developing countries provided by these sources is estimated to have declined from almost 60% in the late 1960s and early 1970s to close to 40% recently. With the slowdown of bank lending to the LDCs, it is essential that more official, and long-term, financing be forthcoming to help reverse this trend.

One of the principal advantages of substituting official financing, bond issuance, or equity investment for bank lending is that many of the development projects undertaken by the LDCs require longer-term financing than can be extended by commercial banks. Hydroelectric dams, for example, may take seven to eight years to construct and have a payout period of about 20 years.

Increased foreign direct investment is vital because it provides a means for developing countries to finance their current account imbalances without adding to their immediate external debt burden. The balance of payments cost incurred in the form of profit remittances is directly related to the commercial success of a venture. Developing countries increasingly seem to recognize these advantages, with net direct investment flows to all LDCs from industrial countries rising from about \$2 billion in 1970 to nearly \$15 billion in 1982, of which over a third is accounted for by the 21 major LDC borrowers. This represents an average annual increase of 17% in nominal terms and 6% in real terms. In part, the increased emphasis on foreign direct investment reflects growing disenchantment with socialist experiments in a number of LDCs. Nonetheless, it may be difficult to sustain this real rate of increase in the future, considering the diminished growth prospects of many LDCs and the stiff competition they face from industrial coun-

tries, which receive about two-thirds of all foreign direct investment inflows.

Need to restore LDC growth

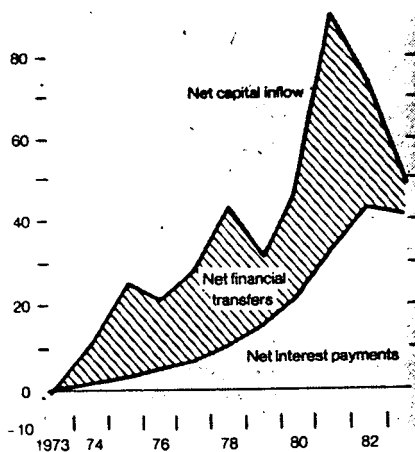
The debt issue is further complicated by the fact that there is need to restore LDC economic growth as soon as possible, while LDC debt/export ratios and bank credit concentrations are being reduced. There has been little or no economic growth in Latin America over the past two years after having averaged about 5½% per annum in the 1970s. Several countries such as Argentina and Chile, already have experienced very sharp reductions in real GNP, and Brazil and Mexico face declines of 3%-6% this year. The LDCs are a significant market for industrial-country products, accounting for nearly 40% of U.S. exports (nearly 3% of GNP) and 28% of OECD exports (over 4% of GNP). Reductions in their import demand necessitated by the slowdown in international lending contributed to delaying U.S. economic recovery last year and could dampen the upturn. A uniform 3% cutback in LDC growth, for example, is estimated to lower OECD growth by 0.8% and U.S. growth by 0.5% (see Table 4). The impact on the United States would be even greater if cutbacks were concentrated in Latin America, as has been the case.

There are also important political and strategic interests at stake. Considering the slowing of LDC economic growth that has already taken place, especially in Latin America, further substantial cutbacks in living standards could increase political and social tensions. Unduly harsh adjustment, in turn, would raise the risks of a moratorium on repayment of principal or interest, particularly if new financing also dried up.

To reduce these risks, therefore,

Chart 4

Net financial transfers to LDCs in billions of dollars



the aim should be to resume LDC economic growth within a couple of years and to ensure that additional bank and official financing is forthcoming. If LDC debt accumulation is to slow relative to exports, however, the adjustment process implies that an increasing share of LDC exports rather than new borrowings would be used to meet interest payments. Hence, net financial transfers (net capital inflows minus net interest payments) must, at some point, turn negative. Such transfers to the 21 major LDC borrowers have averaged about \$25 billion per annum since the mid-1970s (see Chart 4), but they are expected to drop to only about \$3 billion this year and to turn negative thereafter. This swing, from a sizable positive position to a large negative position, is likely to imply sustained lower LDC economic growth, unless one of several developments occurs such as: (1) a substantial increase in LDC savings rates by amounts equivalent to 3%-4% of their GNP and/or increased productivity growth resulting from

improved domestic resource allocation; (2) lower interest rates in the industrial countries, which would reduce the implied real resource transfer from the LDCs to the industrial countries; and/or (3) a sharp boost in LDC exports brought about by changes in LDC economic policies, faster world economic growth, and more open access to LDC products in industrial-country markets.

External debt and financing prospects

The need to formulate a long-term strategy to deal with the international debt problem reflects a judgment that it will take substantial time — perhaps five years or longer — for developing countries, especially those with high debt/export ratios, to regain more regular market access. This assessment is based on balance of payments models for ten key LDC borrowers individually and for a composite of the 21 principal LDC borrowers.

The base-case assumptions about world economic conditions shown in Table 5 are:

1. A moderate OECD recovery that begins in 1983 and gathers strength in 1984-85, averaging 3½% per annum, with 3% per annum growth thereafter.
2. Industrial-country inflation, as measured by wholesale manufactures' prices in local currency terms, that rises gradually from an average of 4% in 1983 to 6% per annum in 1985 and thereafter.
3. Some softening of the dollar later this year and continuing into 1984-85, but which still leaves the dollar about 10% above its 1975-79 average on a real effective basis.
4. Interest rates, as represented by LIBOR for 6-month Eurodol-

Table 5

Base case: global assumptions % changes unless otherwise noted

	1983	1984	1985	Annual averages 1986-1990
OECD real GNP growth	2.0	3.5	3.5	3.0
OECD inflation (manufactures prices, \$ terms)	4.0	8.0	8.0	6.0
OECD inflation (local currency terms)	4.0	5.0	6.0	6.0
Dollar effective exchange rate change	0	-5.0	-3.0	0
6-month LIBOR (Eurodollars, %)	9.25	8.5	9.0	9.0
Oil prices (OPEC average, \$/barrel)	28	29	32	0% p.a. ¹
Non-oil commodity prices				1.4 ¹
Foods	-2	11	8	2 ¹
Tropical	-6	12	10	2 ¹
Grains and feeds	3	9	7	2 ¹
Industrial products	13	15	12	0 ¹
Metals	18	19	13	0 ¹
Fibers	4	6	11	0 ¹

¹In real terms.

Table 6

21 major LDC borrowers: current account and external debt in base-case scenario

	Current account							
	\$ billions				% of exports¹			
	1982	1983	1985	1990	1982	1983	1985	1990
21 major borrowers	-61	-41	-28	-34	-22	-15	-8	-5
Argentina	-2.4	-0.6	-0.7	2.3	-25	-5	-5	9
Brazil	-16.3	-7.2	-6.0	-3.5	-69	-29	-20	-6
Chile	-2.4	-0.7	0.1	0.0	-41	-11	1	0
Colombia	-2.3	-1.8	-0.9	-0.8	-44	-39	-16	-7
Mexico	-2.7	-3.0	-0.9	-4.6	-8	-9	-2	-5
Venezuela	-3.5	-1.2	-2.3	-5.9	-17	-7	-12	-19
Indonesia	-6.6	-6.7	-3.3	-5.3	-32	-39	-14	-14
Korea	-2.5	-2.6	-1.5	3.0	-9	-9	-4	4
Philippines	-3.3	-2.9	-2.0	-2.7	-41	-32	-17	-13
Turkey	-1.4	-0.6	-1.4	-1.1	-14	-5	-10	-4

	External debt							
	\$ billions (end of period)				% of exports²			
	1982	1983	1985	1990	1982	1983	1985	1990
21 major borrowers	514	557	619	822	178	196	166	123
Argentina	38.8	41.8	44.7	44.6	388	349	302	179
Brazil	86.3	94.9	104.7	121.9	345	367	333	219
Chile	17.2	18.3	17.8	17.7	285	258	187	116
Colombia	10.2	9.9	11.1	14.4	186	216	183	132
Mexico	84.6	91.0	95.5	116.7	253	269	199	124
Venezuela	33.2	31.6	37.5	69.6	155	195	190	213
Indonesia	21.9	26.2	33.4	52.9	98	137	135	133
Korea	37.2	40.7	47.0	50.5	121	130	111	64
Philippines	20.7	22.5	25.0	30.6	233	239	197	143
Turkey	22.6	23.6	25.7	33.7	226	216	184	130

¹Exports of goods and services.²Average debt for year as percent of exports of goods and services.

lars, that decline to an average of 8½% next year and to average 9%, or 3% in real terms, in the second half of the 1980s.

5. Oil prices, as measured by the effective average OPEC price, that average \$28/barrel in 1983, rise to \$32 by 1985, and remain constant in real terms thereafter.

6. Prices of non-oil commodities, as measured by a composite dollar index, that increase by about 25% between 1982 and 1985, which would reverse more than two-thirds of their nominal decline between 1980 and 1982. In real terms, they would recover only one-quarter

of their 1980-82 decline of 21% by 1985 and about two-thirds by the end of this decade.

Under these conditions, it is estimated that exports of goods and services of the 21 major LDC borrowers would grow at an average rate of 11½% per annum in the rest of this decade. With imports declining again in 1983 and increasing only 10% next year, their aggregate current account deficit is projected to drop by about \$34 billion, from \$61 billion in 1982 to \$27 billion in 1984. In relation to exports of goods and services, the current account deficit would fall sharply, from 22% in 1982 to 9% in 1984, and continue declining to about 5% in the latter part of this decade (see Table 6). Total external debt in relation to exports, however, would fall more gradually, from nearly 180% in 1982 to about 165% in 1985 and about 125% by 1990.

The overall results for major LDC borrowers are quite sensitive to changes in key assumptions about world economic conditions from those used in the base case. Table 7 indicates the results of alternative assumptions for individual variables, rather than depicting alternative scenarios in which several variables are changed simultaneously. As shown in the table, the greatest sensitivity is to the OECD growth rate, where a 1% change from the base case beginning in 1984 can affect the current account balance by about \$11 billion (or 3% of exports) in 1985 and approximately \$85 billion (14% of exports) by 1990. The debt/export ratio would scarcely improve during the remainder of the decade if the OECD growth rate were 1% lower than in the base case. The results are also very sensitive to a 1% per annum change in the terms of trade after 1983, particularly as the effects accumulate through the remainder of the decade. A 20% change in oil prices

Table 7

21 major LDC borrowers: sensitivities to changes in assumptions from base case¹

	Current account				% of exports ²			
	\$ billions							
	1982	1984	1985	1990	1982	1984	1985	1990
Base case	-61	-27	-28	-34	-22	-9	-8	-5
OECD real GNP growth rate								
+1% point		-23	-17	54		-7	-5	7
-1% point		-31	-38	-112		-10	-11	-20
Terms of trade								
+1% p.a.		-24	-21	18		-8	-6	3
-1% p.a.		-30	-37	-89		-10	-10	-14
Oil prices								
+20%		-17	-15	-2		-5	-4	-0
-20%		-37	-41	-65		-13	-12	-11
LIBOR								
-2% points		-17	-17	-17		-6	-5	-3
+2% points		-37	-39	-56		-12	-11	-9
	External debt				% of exports ³			
	\$ billions (end of period)							
	1982	1984	1985	1990	1982	1984	1985	1990
Base case	514	582	619	822	178	182	166	123
OECD real GNP growth rate								
+1% point		578	605	568		178	158	80
-1% point		585	632	1055		185	174	173
Terms of trade								
+1% p.a.		578	608	660		181	164	102
-1% p.a.		585	630	993		182	168	144
Oil prices								
+20%		575	600	687		171	154	99
-20%		588	638	957		194	180	149
LIBOR								
-2% points		572	598	728		181	163	110
+2% points		592	640	930		182	170	137

¹Changes in assumptions apply from 1984.²Exports of goods and services.³Average debt for year as percent of exports of goods and services.

from those assumed in the base case likewise has significant effects. For the 21 major borrowers the net effect of higher oil prices is favorable, reflecting the fact that the benefits are heavily concentrated among the nine net oil exporters in the group. By contrast, the unfavorable consequences for net oil importers are more widely dispersed. A two-percentage-point change in interest rate levels after 1983 has a strong immediate

impact on current account performance, although over time the effects are less pronounced than those from the 1% change in OECD growth rate, the 1% per annum change in terms of trade, or a 20% change in oil price levels.

While the baseline results for the major LDC borrowers in the aggregate indicate an overall improving trend in both current account and debt ratios, there are important differences among individual borrowers. The current account performances of most of the ten individual borrowing countries shown in Table 6 improve substantially by 1985. The deficits of Argentina, Mexico, and South Korea narrow to 5% or less of exports, and Chile moves into equilibrium. Current account improvements notwithstanding, debt/export ratios for many of the ten countries shown in the table exhibit only limited declines between 1982 and 1985, indicating that considerable time is required, even under moderately favorable conditions, to reduce relative debt burdens. By the end of this decade several of the major borrowers would still have debt/export ratios close to or exceeding 200%.

Under the baseline scenario, the additional external debt buildup of the 21 major LDC borrowers is estimated to exceed \$300 billion in the remainder of the 1980s, or nearly \$40 billion per annum. This compares with debt buildup of \$385 billion from 1975 to 1982, or \$55 billion per annum. The projections imply an average growth of LDC external debt of about 6% per annum (virtually no growth in real terms), or about one-quarter of the annual rate of increase since the mid-1970s. But there is considerable country variation, ranging from a low of less than 1% per annum in nominal terms to a high of nearly 12% per annum.

If there were no change from the

past and banks were counted on to provide about two-thirds of the LDC financing, the bank debt of the major borrowing countries would rise by close to \$200 billion over the rest of this decade, or roughly \$25 billion per annum. That would imply close to a 7% per annum rate of expansion for bank lending, and a 9%-10% rate for the larger U.S. banks in the event they covered shortfalls of the smaller, regional banks. As indicated earlier, however, the nonbank share of financing to the developing countries needs to be expanded to provide more long-term development assistance. Without additional official assistance and foreign direct investment, financing to the LDCs could fall short of that envisioned in the baseline scenario, considering the reluctance of smaller, regional banks to extend new credits to LDCs and the desire of the larger banks to reduce credit concentrations.

Although there would be faster LDC current account and debt/export improvement under more favorable global economic assumptions, and correspondingly lower LDC financing requirements, it is important to keep in mind that the baseline scenario presented is relatively optimistic. It assumes that the remaining impediments to OECD economic recovery are overcome and are followed by a period of steady economic growth, moderate inflation, and no rise in interest rates. There could well be favorable surprise developments in the LDCs, such as reflows of previous flight capital in some countries or greater upturns in individual commodity prices than those envisioned. But, on the negative side, allowance should be made for adverse developments such as upturns in interest rates, a dollar that remains strong for a longer period than in the base case, or political setbacks

in developing countries, each of which could affect LDC repayment prospects and banks' willingness to lend. Counting on a more optimistic appraisal than that assumed in the base scenario for policy decisions would be attempting to wish the international debt problem away.

Alternative strategies

The various proposals that deal with the international debt problem fall into two basic classes. One is a relatively optimistic, laissez-faire school that assumes the current debt situation is a fairly short-term liquidity issue to be solved primarily through deflationary policies in the LDCs designed to promote balance of payments adjustment. Such adjustment, together with prospects for some OECD recovery, would provide the needed boost in LDC exports and current account improvement. Some proponents feel that banks would resume new lending fairly quickly even if some losses are incurred on existing obligations. Accordingly, advocates of this proposal downplay the need for stepped-up official assistance other than on a strictly temporary basis.

The principal advantage of this approach is that it properly stresses the importance of LDC adjustment or internal policies and recognizes the impressive long-term benefits that can be reaped through sound economic policies in these countries. Experience has demonstrated that, particularly in a favorable external environment, an individual country's overall payments position can improve significantly within a couple of years following the adoption of sound adjustment programs. This was true of Turkey, which adopted an austere stabilization program in a favorable environment of rapidly expanding Middle Eastern export markets. Such programs are

Several key elements need to be incorporated in this third course.

- 1 One is moderate OECD recovery.
- 2 Another is recognition that considerable time will be required for some high-debt LDCs to reduce their debt/export ratios. A third is for the LDCs to pursue restrictive
- 3 demand-management policies over the next couple of years to achieve a "front-end" loading of current account adjustment, although over the longer term adjustment efforts must also entail more export-oriented policies in the LDCs and greater access to industrial-country markets.
- 4 A fourth element is creation of positive incentives for banks to provide additional financing to LDCs, rather than imposition of such disincentives as existing obligations. Finally, it is important that bank financing increasingly be supplemented by
- 5 additional official assistance, not merely to address temporary balance of payments needs, but also for longer-term development.

The success of this long-term strategy very much hinges on rebuilding lenders' confidence in the prospects of the developing countries' ability to service their external debt. Above all, the participants must have confidence that the type of scenario portrayed in the base case is attainable, and not wishful thinking. As regards OECD growth, there are still considerable doubts about the prospects for sustained recovery. Although U.S. recovery appears on track and monetary policy has been highly accommodative, there is still uncertainty about the direction of U.S. interest rates because of the prospective large U.S. budget deficits. Moreover, economic policy and outlook in Europe and Japan are not as promising as in the United States. Europe is plagued by high and rising unemployment, large budget deficits in some countries, and considerable wage rigidities. Also, a European economic re-

covery is highly contingent on Germany, where modest growth is foreseen. In Japan economic growth is well below potential, and signs of recovery are still quite faint. However, in both Germany and Japan fiscal policies are slated to be tightened. Given the substantial economic slack in both countries and their relatively strong balance of payments positions, the overall thrust of economic policies in those countries could be more mildly expansionary for the time being without rekindling inflation or inflationary expectations. At the same time, it is essential that open market-access be assured for developing-country products, so that the LDCs can reap the benefits of industrial-country growth.

Beyond this, lenders must have confidence that adjustment efforts in the developing countries will be sufficient to bring debt levels more in line with debt-servicing capabilities. For the proposed strategy to work, it is particularly important that current account adjustment be heavily concentrated in the next couple of years, as called for in the baseline scenario. Since interest payments compound over time, a slowing of the LDC debt buildup in the next few years can reap more-than-proportionate gains in reductions of debt/export ratios in later years, thereby paving the way for a much quicker restoration of market access and economic growth. In this regard, comprehensive adjustment measures and resolute implementation of IMF stabilization programs are indispensable to rebuilding confidence and to attracting private capital. In the same vein, programs that do not deal adequately with the need for adjustment, or with which compliance is lax, can only erode confidence and hinder a return of capital.

With the IMF now more involved in the major borrowing

essential to restore confidence in a borrowing country and to create incentives for banks to commit new funds.

However, heavy reliance on deflation as a solution entails high risk. The strategy stresses the need to slow LDC debt accumulation through current account adjustment. Its chief shortcoming is underestimating the time required to reduce the relative debt burdens of several of the major LDC borrowers in an environment where many countries must settle for relatively low economic growth. Furthermore, as Turkey's experience attests, even when there is substantial current account improvement it still may take considerable time for countries to regain more regular access to financial markets. By ignoring long-term structural elements of the international debt problem or overstating the prospects for global recovery, this approach risks forcing excessive deflationary costs on borrowers. It is also overly optimistic about market forces providing ample new financing.

At the other extreme are proposals that reflect a pessimistic view of the LDC debt situation. Their proponents see the situation essentially as structural, and not solvable in a relatively short period by LDC adjustment or modest OECD recovery. Because of the time required, their main concern is that current reliance on IMF adjustment programs will unduly jeopardize economic growth prospects in the LDCs, creating political and social strains in those countries, and in turn adversely affect industrial-country growth. Accordingly, they seek to eliminate the debt overhang fairly quickly, by writing off, and/or transferring sizable amounts of LDC debt to new institutions. At the same time, they seek to step up official assistance through various means, including SDR creation, to

deal with shortages of international liquidity. They also stress the need for the industrial countries to adopt more expansionary policies to promote a strong recovery even if it generates higher OECD inflation.

The virtue of this more inflationary approach is that it recognizes the severity and duration of the debt problem, considering the impediments to sustained LDC adjustment and OECD recovery. Its main shortcoming is that, since writing off portions of existing obligations would be extremely costly to lenders and impair banks' capital, it would jeopardize new flows of money to the LDCs and to domestic borrowers, as well. Choking off new loans has the risk of precipitating crisis situations, rather than avoiding them, in effect turning good debt into bad debt. The proposals also tend to understate budgetary restraints in the industrial countries that limit new infusions of official funds. Furthermore, they tend to ignore important differences among developing countries, applying the same treatment to all borrowers, irrespective of the need for debt relief. As a result, there would be strong incentives for countries to seek debt relief even when they do not need it.

A third course

Given the shortcomings of the two alternative approaches outlined above, there is growing awareness of the need to develop a third course that takes positive elements from the two former approaches and strives for a more careful balance between adjustment and financing. Such a strategy was discussed and endorsed by leaders of the major industrial nations at the Williamsburg summit. However, specific details have yet to be worked out.

countries, it acts as a catalyst to assure new bank financing. Accordingly, the Fund's role vis-à-vis the borrowing countries can be expected to change, so that it provides those countries with more regular guidance than in the past on appropriate debt levels, both total and short-term, as well as on policies that will enhance export prospects. To be effective both with borrowers and lenders, however, the Fund must have adequate resources. The proposed 47% increase in IMF quotas and enlarged General Arrangements to Borrow (GAB), therefore, are absolutely essential. Furthermore, when the quota increase takes effect, the countries' access to the IMF should not be scaled back from the present 450% of quota, so as to permit them to return to the IMF for a second time.

While the IMF can provide leadership in marshaling balance of payments support to developing countries, it is particularly important that increased long-term development assistance from the World Bank and other multilateral lending institutions be forthcoming. In recent calls for a new Bretton Woods system, too much emphasis seems to be placed on the need to reform the exchange rate system, and insufficient attention has been devoted to the critical issue of development finance and the need to expand the activity of the World Bank and the various regional development assistance institutions. Considering that the debt problems of some LDCs could well take most of this decade to resolve, development finance can no longer be neglected. A first step would be to advance the timing of the planned doubling of the capital of the World Bank, which is now slated for 1986.

Ways must also be found to increase the leverage of both the IMF and World Bank to induce new flows of bank credits to the LDCs

without tapping the budgets of the member countries. Current reliance on moral suasion and arm-twisting may work in an emergency period, but will not ensure adequate bank financing when countries do not have regular access to bank credit.

Both institutions could consider new ways of encouraging banks to supply additional financing. Although in the past some of the resources of the World Bank and Fund were set aside to assist the poorest countries, through the establishment of IDA in the World Bank and the Trust Fund in the IMF (which was financed out of profits derived from sales of IMF gold), thought should also be given to aiding the hard-hit higher- and middle-income LDCs. Some of the IMF's assets conceivably could be set aside for developing countries to establish an insurance pool to provide backing for portions of international loans to LDCs called for as part of IMF-stabilization programs. Developing countries would pay insurance premiums, but receive a lower LIBOR spread because of the IMF guarantee. The objective of such an arrangement would be similar to that of IMF borrowing from private markets, but it would have the advantage of keeping channels of private credit open directly to the LDCs. Similarly, a way of expanding World Bank activity would entail participation with banks in Eurocurrency syndications, possibly through the creation of a new subsidiary. Credits extended would be at commercial rates and tied to World Bank project loans. In the event a country failed to meet regular payments on such credits, disbursement of ongoing World Bank project loans to the country would be halted, creating strong incentives for these credits to be serviced. Such schemes not only would help stimulate further commercial bank money, but partic-

ularly, close ties with the World Bank would help promote project-related lending and improve control over the use of loans to the benefit of economic growth in the borrowing countries.

Steps also have to be taken to ensure that additional foreign direct investment is forthcoming. The baseline scenario projects such flows to the major LDC borrowers to double, from over \$5½ billion in 1982 to \$11-\$12 billion at the end of the decade. This would represent an average annual increase of about 10% in nominal terms and 3%-4% in real terms, but a higher rate would be desirable. In this regard, the IMF and World Bank could play useful roles in advising LDCs on appropriate tax, pricing, and exchange rate policies to attract foreign capital. Beyond this, there is need to clarify and strengthen rules and institutional arrangements to protect foreign investment from government intervention, possibly within an internationally negotiated framework.

Compared with the alternative strategies, the third course that has been outlined is the least disruptive to both lenders and borrowers. It allows for gradual reductions of LDC debt/export ratios and

concentrations of bank credits to LDCs. It calls for concerted action on the part of all the participants to resolve the debt problems of most of the LDCs within a five-year span or by the end of this decade for some of the high-debt LDCs. Adherence to this long-term strategy would require the major LDC borrowers to pursue economic policies to reduce their current account deficits — with the goal of cutting their combined deficit roughly in half in the next couple of years — and to build their long-run export potential. Such efforts need to be aided by policies in the industrial countries that would open markets for LDC products and provide for noninflationary growth. The banks would be expected to supply additional financing and to restructure, but not reduce, existing obligations, while official institutions would provide increased long-term assistance to LDCs, gradually reducing the share of LDC financing provided by the banks. In all this, skillful and cooperative management is required on the part of governments, banks, and official institutions. For while the international debt situation is manageable, it will not manage itself.

Statistical appendix

for key to data in tables
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